Several commenters suggest that providing any pricing flexibility with a showing of potential competition (Phase I) is inappropriate.[51] Yet, characterizing Phase I as only potential competition is incorrect. As discussed above, a substantial competitive foundation already exists. Phase I builds upon the existing competitive alternatives. Hence, Phase I represents the potential for competitive expansion and additional new entry. For this reason, the appropriate competitive trigger is the existence of a negotiated or arbitrated interconnection agreement approved by the state commission as called for under Sections 251 and 252 of the Telecommunications Act.[52]

An approved interconnection agreement, together with the other requirements of Section 251, *i.e.*, resale, reciprocal compensation, number portability, dialing parity, access to rights of way and conduit, access to unbundled network elements, and collocation, as well as Section 252's continuing obligation to negotiate further agreements, set the stage for a rapid expansion of competition. Now is the time for the Commission to make improvements to its regulations to permit LECs to operate more like their competitors.

Further, the flexibility that would be obtained under Phase I, as proposed by BellSouth, could hardly be viewed as deregulatory as some commenters believe.[53] LECs would still be subject to price cap and tariff regulation. Any service offered through contract carriage would still be subject to the nondiscrimination provisions of the Communications Act. Accordingly, any

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[51] *See, e.g.*, MCI at 44-45.

[52] 47 U.S.C. §§ 251 and 252. Section 252 permits a LEC to file a statement of generally available terms subject to the approval of a state commission. 47 U.S.C. § 252(f). Such statement must comply with Section 251 in order to be approved by the state commission. 47 U.S.C. § 252(f)(2). Accordingly, the approval of such a statement by a state commission would be sufficient to trigger Phase I regulatory relief.

[53] *See, e.g.*, ACC at 7-9.

similarly situated customer (including a competitor that chooses to engage in resale) would have the opportunity to obtain a service offered under contract carriage. In a similar context, affording LECs the ability to respond to a competitive request for proposal does not constitute the granting of unfettered pricing flexibility. Responding to a request for a competitive bid is a fairly narrow construct that by definition evidences the availability of competitive alternatives.[54] More importantly, the fact that all of the LEC's offerings would be provided under tariff affords the Commission with a ready means to detect any pricing behavior that is inconsistent with the requirements of the Communications Act.

With regard to Phase II, commenters suggest that actual competition be evidenced through showings of extensive competition for LEC services. The key for Phase II relaxation should be a showing that there is an adequate market check on the LECs' conduct. As BellSouth demonstrated in its comments, the most relevant competitive factor is the elasticity of supply. The more elastic the prevailing conditions of supply are, the less possible it is for the LECs to raise prices and limit output. Where a market segment is characterized by a high elasticity of supply, even small price increases will elicit large expansions in output.

Elasticity of supply is determined by a variety of factors, although two predominate. The first is the supply capacity of existing competitors. If competitors have or can acquire significant additional capacity, then supply elasticities tend to be high. Even if existing competitors do not have substantial excess capacity, another factor, conditions of entry, can establish that a market is

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[54] *See* GSA/DOD at 24 ("A local exchange carrier would not be able to submit a competitive response tariff if competition were not present, so that a test reflecting the general development of competition is not required").

characterized by high supply elasticity. If economic and non-economic barriers to entry are removed, a fair opportunity for self-policing competition is created.

Accordingly, the appropriate Phase II trigger is actual implementation of an interconnection agreement. The trigger would require competitive carriers to be providing local services in competition with the LEC pursuant to the agreement. In other words, the trigger is the demonstration that barriers to entry are removed.[55]

IV. THE COMMISSION SHOULD NOT ADOPT A PRESCRIPTIVE APPROACH TO ACCESS CHARGE REFORM

In its initial comments, BellSouth expressed the view that carriers and consumers will reap the most public interest benefit from a regulatory approach to access charge reform that permits market forces, rather than regulation, to determine how quickly access prices will move toward costs. This is certainly the direction in which the Commission -- wisely, in BellSouth's view -- has been moving in a variety of regulatory initiatives, the implementation of price regulation for the LECs chief among them. It is also the policy underpinning of the Telecommunications Act, which has the stated Congressional purpose of creating a "pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[56]

Even the large IXCs do not dispute (because they cannot) that market forces are better than regulators at "getting it right" with respect to access charge pricing. Instead, their strategy is to pay lip-service to competitive principles, even while they seek to persuade the Commission to

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55 This trigger will also enable the ready identification of geographic areas that should be subject to Phase II regulatory relaxation.

56 1996 Act Conference Report, Report No. 104-458, 104th Cong., 2d Sess. (1996), at 1.

use the blunt instrument of prescriptive TSLRIC/TELRIC-based pricing to effect a massive wealth transfer from LEC to IXC shareholders.

BellSouth and others have shown that there simply is no legal or public policy predicate for the "central planning" of access charge prices. To the extent that the Commission intervenes in the marketplace, it should be done in a manner that preserves LEC productivity incentives; that is consistent with the market-oriented competition policies that the Commission has previously pursued; and that is consistent with the policy decisions underlying the 1996 Act.

Furthermore, the record is replete with reasons why the Commission cannot and should not implement access charge reform without permitting LECs the opportunity to recover their total costs. LECs have a legitimate, investment-backed expectation that they will be permitted to earn a compensatory return on the total costs of deploying their networks. There is no basis for the Commission to now back away from that regulatory bargain merely because the IXCs demand it.

A. A Prescriptive Approach To Access Reform Is Unwarranted

The proposition advanced by some commenters that a "market-based approach cannot be relied upon by the Commission to lower access charge rates unless and until competition develops" is a *non-sequitur*.[57] While current local exchange and exchange access *markets* may not be sufficiently capable of constraining access prices in some areas today, this fact does not mean that the Commission should not incorporate and rely upon competitive *market principles* in crafting its access reform approach. Indeed, the variations on the Commission's proposed market-oriented transition framework that BellSouth and others have proposed are designed

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[57] *See, e.g.*, Ad Hoc at 35.

precisely to anticipate and encourage the development of competition in the local exchange and exchange access marketplace, and to relax or eliminate LEC regulatory constraints in a manner coincident with the introduction of competition.

It is plain that a Commission decision to rely on market forces has numerous policy advantages. These include:

> 1) The flexibility to use more efficient mechanisms to recover shared and common cost, including volume and term discounts and other forms of non-linear pricing, that would be hard to employ under a prescriptive approach;[58]
>
> 2) Market forces more closely align consumer preferences and tastes with costs than can ever be expected under a prescriptive approach, resulting in greatly improved efficiency;[59] and
>
> 3) Reliance on market forces guarantees that society's scarce resources are put to their most productive needs and ensures economic efficiency.[60]

By contrast, a prescriptive approach distorts efficient outcomes, and would significantly increase involvement of the Commission at a time when competition and market forces should be the principal mechanisms in determining efficient output levels.[61]

Indeed, a prescriptive approach rests upon a flatly incorrect characterization of the local marketplace, and for that reason, is likely not sustainable. As Dr. Kenneth Gordon, former head of the Massachusetts and Maine PUCs, has noted, increasing pressure for access rates to become more efficient is already happening *now*, due to (1) efficiency and productivity incentives of the FCC's price cap plan for regulating access rates; (2) the emergence of competitive access

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[58] R. Schmalensee & W. Taylor, NERA, "Economic Aspects of Access Reform" (Jan. 29, 1997), USTA Comments, Attachment 1, ("Schmalensee & Taylor"), at 2.

[59] *Id.*

[60] *Id.*

[61] *Id.*

providers in the latter half of the 1980's and their general evolution into CLECs;[62] (3) technological changes, such as fiber optics, that make it easier for access alternatives to develop on a larger scale; and (4) the availability of unbundled network elements under the cost-based pricing standard of the 1996 Act. All of these forces will accelerate the transition to competition and introduce exchange access alternatives to all geographic areas.[63] And, as Professors Schmalensee and Taylor observe:

> A prescriptive approach that moves access rates to levels which more accurately reflect competitive levels over a certain time period runs the risk of not being sustainable due to the presence of market forces and the unbundling requirement of the Act. For example, a prescriptive approach which moves current access rates over a five-year period may run the risk of not being sustainable, and worse irrelevant, if market forces constrain access rates prior to the end of the five-year period. A prescriptive approach does not eliminate the fact that market forces and the unbundling requirements of the act will continue to reform the access market. A prescriptive approach, therefore, becomes all the more difficult and may become irrelevant in the presence of market forces. Worse, a prescriptive approach may confound desirable market outcomes. *Schmalensee & Taylor* at 17.

In a telecommunications marketplace that each day grows increasingly competitive, and that is now poised for a period of even more dramatic competitive development following the sweeping changes effected by Congress in the 1996 Act, the Commission should craft market-oriented approaches to access charge reform designed to spur productivity and competitive growth. It should not impose wrong-headed, confiscatory access prices that threaten to impede

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62 *See* BellSouth CAP Status Report.

63 K. Gordon, NERA, *Access, Regulatory Policy, and Competition* (Jan. 29, 1997), Attachment B to Comments of Ameritech, at 21 ("Gordon Statement"); see Schmalensee & Taylor at 2 (noting that the transition from the current level of exchange access rates toward their competitive levels has been underway for sometime, and that in conjunction with efficiency improvements elicited from price regulation, technological changes and market forces are restructuring the exchange access market).

the very development of facilities-based competition that all agree the Commission should strive to promote.

B. A Prescriptive Approach Will Undercut LEC Productivity Incentives And Is Fundamentally Inconsistent With The Commission's Price Cap Regime

Given the increasingly competitive state of the LEC marketplace, there is every reason for the Commission to give market forces a chance to operate in constraining access prices before it intervenes in a manner that is directly contrary to the spirit of the 1996 Act and the Commission's own regulatory policies. The large IXCs, however, would have the Commission turn back the clock on seven years of incentive regulation,[64] and return to a regime of prescriptive regulatory determinations of LEC costs and prices. MCI's expert, for example, lauds the benefits of "cost-based" access reform, and urges the Commission to "avoid the pitfalls" of price caps through the "simple expedient of mandating socially efficient, cost-based pricing."[65] Although the creation of market-oriented regulatory approaches is the course that both the Commission and the Congress have charted to guide competition policy into the next century, AT&T and MCI would reverse it 180 degrees.

Price caps rely on indices representing expected cost changes, which provide incentives for the regulated company to be more efficient than the index presumes; the prescriptive approach, on the other hand, requires the setting of rates based on an administrative determination

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[64] As Professor Crandall has observed, regulatory commissions in general and the Commission in particular have been quite cognizant of the adverse incentive effects of cost-based regulation. *Affidavit of Robert W. Crandall*, Attachment to Comments of Bell Atlantic (Jan. 29, 1997) ("Crandall Affidavit"), at 2.

[65] J. Kwoka, "Statement on LEC Price Cap Reform," Attachment 1, Comments of MCI (January, 1997), at 24.

of prudent costs.[66] Beyond being unnecessary for the development of competition for access and interexchange services and an unwarranted intrusion into the workings of the competitive process, the proposals of MCI and AT&T to reinitialize price cap indices based upon mandatory cost-based rates constitute an abandonment of the incentive principles that underlie the Commission's price cap rules.[67] They would represent "a step back from the market-based incentives of price caps and the Commission's commitment to the introduction of competition on economically efficient terms."[68]

Such an abrupt policy reversal might be understandable if there was sound evidence that the public interest would benefit from such intrusive Commission action.[69] But there has been no such evidence proffered here. To the contrary, as Bell Atlantic rightly observes, in the

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66 *See Gordon Statement* at 23.

67 *See Schmalensee and Taylor* at 2-3 (Observing that a "prescriptive regulatory approach is a return to cost-based rate-of-return regulation" that "would reverse and undo the incentive-improvement intentions of price cap regulation and subsequent reforms").

68 *Gordon Statement* at 22; *see Crandall Affidavit* at 7 ("If the prescriptive approach to setting interstate access rates on the basis of TSLRIC engineering estimates of these costs is utilized, the Commission would be faced with the possibility of having to return four-square to cost-based regulation. Presumably, TSLRIC-based costs will be below today's embedded costs but different from tomorrow's costs. If the Commission were to specify that the loop (CCL) costs or other components of interstate costs currently recovered through switched carrier access charges are established at TSLRIC or some other measure of "forward looking" costs, it would be faced with adjusting these rates at a later date to catch up with further technical change. Such a process would not only vitiate the price-cap mechanism, but would create a severe disincentive for future investment by the incumbent LECs in their local networks.").

69 *See Schmalensee & Taylor* at 3 (noting that the Commission "should contemplate prescriptive remedies only as a last resort, after convincing evidence that market forces and the requirements of the Act and the Interconnection Order have failed to reform the exchange access market"); *Gordon Statement* at 23 ("Should the market-based approach to access reform fail to achieve its goals, additional work on creating market conditions for competition may be required. Or failing that, a prescriptive approach could be used as a last resort. But the system needs to be tested at this point, not undermined.").

Commission's 1995 review of the LEC price cap plan, the agency reaffirmed its commitment to incentive regulation, noting that price cap regulation improves social welfare by introducing profit incentives and price constraints that more closely replicate the operation of competition than traditional rate of return regulation.[70] The Commission also found that interstate access rates have declined significantly under price cap regulation,[71] that LEC customers had enjoyed a cumulative savings of almost 6 billion dollars;[72] and that LECs had increased their investment in new plant.[73] While the Commission left open the issue of the final determination of the LEC X-Factor, it also emphatically rejected the notion that it would turn back the clock to a regime of cost of service regulation.[74] There is no reason for the FCC to adopt an inconsistent regulatory approach with respect to access charge reform when the evidence (as opposed to IXC rhetoric or invective) highlights the success of the Commission's market-oriented price cap regime.[75]

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70 *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 9002 (1995) ("Price Cap Review Order"); *See* Bell Atlantic at 4-5.

71 *Price Cap Review Order* at 9002.

72 *Id.* at 8987.

73 *Id.* at 8988.

74 *Id.* at 8967, 8973.

75 Indeed, given such findings, as a matter of law, BellSouth believes that a prescriptive reinitialization of price cap rates would be illegal. Ironically, MCI cites Section 205(a) of the Communications Act for the proposition that the Commission must act to ensure that rates are "just and reasonable." MCI at 9. But that is precisely the point. The Commission *has* found that LEC prices that fall below price caps *are* presumptively just and reasonable, and MCI has offered only vague and conclusory speculation of anticompetitive cross-subsidy to justify a radical regulatory change in course. *See* MCI at 13. Under Section 205 of the Act, such assertions are insufficient for the Commission to find that existing LEC charges "are or will be unlawful," and the Commission therefore has no basis for represcribing LEC rates. *See Third Report and Order*, MTS and WATS Market Structure, 93 FCC 2d 241, 256 (1983); *LEC Price Cap Order*, 5 FCC Rcd at 6817, ¶253.

The Commission must not jeopardize the positive benefits of incentive regulation by adopting a prescriptive access reform approach that it knows will blunt LEC productivity incentives.[76] And there is no question that the Commission would indeed be putting at risk the entire future of the benefits reaped by price regulation by adopting a prescriptive approach. A rational regulated company simply "would not make future investments where it would bear all of the risk of failure, while any potential return would be confiscated by the regulator."[77]

A prescriptive approach simply has no place in the pro-competitive deregulatory environment envisioned by Congress when it passed the 1996 Act, nor does it have a place in a price cap world. Any attempt to adjust access rates to a measure of costs, even if defended as a one-time adjustment, would create a dangerous precedent that dilutes the efficiency-enhancing effect of the price-cap mechanism:

> Were such a prescriptive cost-based policy implemented, surely every incumbent LEC would be justified in hesitating to make future new efficient network investments for fear that such investments would trigger new TSLRIC estimates and subsequent price-cap "adjustments" that would deprive it of the benefits of such investments. After all, current estimates of TSLRIC should reflect successful recent investments in local networks that have been induced by the existing price-cap mechanism.[78]

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[76] The *Notice* recognizes that "reinitializing [price cap] indices based on earnings could have a negative effect on productivity incentives of the price cap plan." *Notice* at ¶ 230.

[77] Bell Atlantic at 8. Ironically, if any aspect of access charge reform merits a prescriptive approach, it is the flowthrough of LEC access charge reductions to consumers by the IXCs. Over the period that price regulation has been in effect, LECs have reduced access prices by some $9 billion, while AT&T, MCI and Sprint, by contrast, have raised their prices six times over roughly the same period. USTA at 3. Thus, the Ohio Consumers' Counsel has observed that the "flowthrough of access charge reductions should, indeed, be the centerpiece of any access charge regime," and has recommended a prescriptive approach to a pass-through of access charge reductions. Ohio Consumers' Counsel at 3, 5.

[78] *Crandall Affidavit* at 8.

BellSouth agrees that the Commission should not now weaken the price cap incentive structure -- which has worked well -- by "backsliding into the world of adjudicating reported or estimated costs."[79]

C. The FCC Must Permit LECs To Recover *All* Of Their Costs

AT&T and MCI persist in advocating a prescriptive approach that would reinitialize price cap indices based upon a forward-looking economic cost model, in the process seeking to curtail drastically or disallow entirely any recovery of large portions of LEC costs, such as the embedded cost of past LEC investment in the network or the cost of government-imposed subsidies of residential and other services.[80] This rate prescription is characterized oxymoronically -- and outrageously -- by AT&T as a "competitive pricing" approach.[81] It is of course nothing of the kind. The prescribed TELRIC/TSLRIC access pricing advocated by AT&T and MCI is fundamentally flawed as a matter of economic policy and as a matter of law, and cannot be adopted by the Commission.[82]

First, the advocates of the "blank slate" version of mandated TELRIC prices -- that is, prices based not on estimated incremental LEC costs actually incurred, but instead on the

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79 *Gordon Statement* at 23.

80 MCI at 18; AT&T at 23.

81 AT&T at ii.

82 The Commission argued before the Eighth Circuit Court of Appeals that "the Commission does not think, it has never been the Commission's position that the legitimate embedded costs get stranded; that ILECs should never be able to recover them." *Iowa Public Utilities Board, et al v. Federal Communications Commission*, Nos. 96-3321 *et al*, Oral Argument on Petitions for Review of A Final Order of the Federal Communications Commission at 55 (January 17, 1997). *See also* Economic Report of the President at 204-205 (February 1997). (The report argues that telephone companies should be able to recover the infrastructure costs mandated under prior regulatory regimes).

estimated costs of a hypothetical, completely new network employing the most efficient possible technology and constructed from the ground up -- incorrectly assume that "blank slate" TELRIC is the level to which real competition would drive access prices.[83] Yet, this assumption is pure fantasy. As Professor Kahn has observed, "it would be irrational for firms constantly to update their facilities in order *completely* to incorporate today's lowest cost technology, as though starting from scratch: investments made today, totally embodying *today's* most modern technology, would instantaneously be outdated tomorrow, and in consequence, never earn a return sufficient to justify the investments in the first place."[84]

Second, the TELRIC-prescribed prices advocated by AT&T and MCI would destroy incentives for efficient entry by LEC competitors. The TELRIC price for a service offered by the incumbent firm would be based upon the forward-looking variable and fixed costs of that firm, ignoring sunk costs (i.e., costs previously incurred, but not necessarily recovered, in the provision of the service). Some of these sunk costs are costs that a new entrant would have to incur in order to offer a service competitive with that of the incumbent firm. The new entrant would need to set a price sufficient to recover all costs caused by entering the market and providing the new service. With the incumbent's price set at a TELRIC-prescribed level, a new entrant would likely <u>not</u> be able to price its service at a level sufficient to recover its costs. Therefore, it would not enter the market. This failure to account for sunk costs not only deters efficient facilities-based

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[83] *See Letter to Hon Reed E. Hundt, Chairman, Federal Communications Commission from Alfred E. Kahn*, dated Jan. 14, 1997 ("Kahn Letter"), at 2-3.

[84] *Id.* at 2-3. *See also Schmalensee & Taylor* at 21 ("Prices cannot fall to levels indicated by installing ubiquitously the most efficient technology at any instant. An efficient firm in the real world adds capacity to its existing plant thus accounting for the trade-off between lower unit costs for larger installations and the costs of carrying unused capacity over time.").

entry, but also transmutes recent facilities-based entrants -- having incurred what AT&T's experts acknowledge are "large-scale sunk set-up costs"[85] -- immediately into unprofitable ventures. And to the extent that CAPs are deterred from entering even the dense, urban markets that they must enter before extending service into less dense markets,[86] the absence of entry will ensure inefficient regulation rather than competition in many local markets for years to come.[87] As perverse as this result may be, some, like AT&T, perceive it as an advantage in order to delay BOC entry into the long distance market.

Third, if the Commission were to tie the rates for new services closely to costs, incremental or otherwise, it would fatally attenuate the incentives of both incumbents to develop new and innovative service and of competitors to enter on a facilities basis. The system advocated by AT&T and MCI "would be one in which investors would be forced to absorb the cost of failed ventures -- as in competitive markets generally -- but be denied the offsetting opportunity, essential to innovation in a competitive system, to reap whatever rewards the unregulated market will provide for the ventures that turn out successfully."[88]

Fourth, and in any event, TELRIC or TSLRIC methodologies, whether actual or "blank slate," are the wrong measures of costs as a matter of law because they deny LECs the

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85 *Id.* at 15, ¶32 (emphasis in original).

86 *See* ALTS at 22. ALTS disputes the Commission's conclusion that a prescriptive approach will bring about competition. A prescriptive approach "would lower the prices of incumbent access charges, and thus reduce incentives for competitive entry." *Id.*

87 *See also Affidavit of Professor Jerry A. Hausman* (May 13, 1996), Attachment 1 to Comments of United States Telephone Association (May 16, 1996), CC Docket No. 96-98 ("Hausman") (explaining why TSLRIC does not provide the correct pricing rule when sunk investments are present under certain demand and price situations).

88 *Kahn Letter* at 4.

opportunity to recover joint and common costs; the embedded cost of past LEC investment in the network; and the cost of government-imposed subsidies of residential and other services.[89] As BellSouth and others have emphasized, this failure to permit recovery of total firm costs is inherently unfair and blatantly confiscatory.

MCI admits (as it must) that the Takings Clause of the U.S. Constitution is implicated when an agency's regulatory scheme produces rates so low as to jeopardize the financial integrity of regulated companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital.[90] The question, as framed by the courts, is whether the challenged rates will cause "deep financial hardship."[91]

On this point, MCI contends that there can be no plausible showing that TELRIC pricing will impede the LECs' ability to attract capital.[92] The record is simply to the contrary. As Sidak and Spulber observe, "[i]f the incumbent LEC, the putative owner of the local network, no longer can recover the costs of investments that it would make on a forward looking basis -- let alone

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[89] BellSouth agrees that access charges may not be reduced prior to separations reform. The existing Part 36 separations rules provide for the allocation of carriers' fully distributed costs to the interstate jurisdiction on the basis of direct assignment, where possible, relative use, or a 25% allocator. The Commission must convene a Joint Board under Section 410 of the Act in order to change those rules, and until it does, the amount of those interstate allocated costs to be recovered through access charges cannot be reduced. At a minimum, the FCC could not reinitialize price cap indices or prescribe other measures of cost that are inconsistent with the current separations rules. And if access rates are reduced, the Commission must ensure some alternative means of recovery. *See* Pacific Bell at 31-32. *See also* USTA at 79 & Attachment 2 ("[U]ntil and unless separations rules are changed, the Commission must provide the LECs a way to recover the prudently incurred costs they are required by the separations rules to allocate to the interstate level.").

[90] *See* MCI at 30, *citing Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989).

[91] *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987).

[92] MCI at 32.

keep any economic rents accruing to such investments -- then ALECs become free riders and the incumbent LEC's incentive to make further investment in the local exchange network evaporates."[93] Carried to its logical conclusion, this means that the owner of the local network at some point will fall off of a financial cliff, and the quality of the network will deteriorate: "Given the preference of regulators to combine TSLRIC pricing for access and UNEs with a reluctance to impose a competitively neutral, non-bypassable charge (or an increase in the existing charge of that sort), the incumbent LEC will consistently fail to earn revenues from its local exchange operations that will cover their total forward looking costs."[94] In short, it is clear that under prescribed TELRIC or TSLRIC pricing, LEC rates will be inadequate to compensate current LEC equity holders for the risk associated with their investments.[95]

MCI argues that prescriptive action by the Commission to reinitialize LEC price caps to TSLRIC levels will create "certainty for all parties" including for incumbent LECs and their investors.[96] That statement is true. Under MCI's proposed prescriptive approach, it is "certain" that LECs will not recover their total firm costs; "certain" that investor confidence will be undermined by the regulatory breach of prior commitments that LECs would have a reasonable opportunity to recover those costs; "certain" that LEC incentives to invest in their networks will evaporate; and "certain" that the incentives of new entrants will be distorted.

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93 *Affidavit of J. Gregory Sidak & Daniel F. Spulber*, Attachment 3, Comments of USTA (Jan. 29, 1997) ("Sidak & Spulber"), at 29.

94 *Id.* at 30.

95 *Duquesne*, 488 U.S. at 312.

96 MCI at 13-14.

There is indeed a terrible "certainty" to a prescriptive approach -- one that the Commission can and must avoid. The Commission should adopt a market-based regulatory approach, and in all events, should ensure that LECs are afforded an opportunity to recover all of their costs, including all prudently incurred embedded costs.[97]

D. A Prescriptive Approach Is Unnecessary To Resolve Any Concerns With Respect To Terminating Access

Finally, some parties have argued that a prescriptive approach is necessary to address the alleged problem that terminating access "is not and will not be subject to" competitive pressures. Because the carrier providing terminating access in most cases is not chosen by the party paying for the call, these parties argue that the relationship provides no incentive for the carrier providing terminating access to lower its charges to the IXC.[98] BellSouth believes that such concerns are overblown and readily addressed; they do not warrant the imposition of a prescriptive approach.

First, as an initial matter, it is worth mentioning that the scope of the terminating access problem, if there is one at all, will be much lessened once the Commission implements the rate

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[97] MCI claims that there is "no basis in policy analysis" to permit LECs to recover the difference between the current and the historic value of their plant. MCI at 73. That statement is nonsense. BellSouth, USTA and others have shown a variety of economic and policy reasons why ILECs must have an opportunity to recover prudently-incurred costs regardless of the mechanism used to move rates to competitive levels. *See, e.g., Schmalensee & Taylor* at 11. The Supreme Court has observed that a utility is permitted to charge a price that permits it to maintain its financial integrity, to attract capital, and to compensate its investors for the risks they have assumed. *See Duquesne*, 488 U.S. at 310. And other agencies, such as FERC, have recognized the traditional obligation to ensure that utilities have a fair opportunity to recover prudently incurred costs, and to give utilities an opportunity to recover "stranded" investment. *See* Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services By Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 1996 WL 355535, *17 (F.E.R.C.) (Apr. 24, 1996). The Commission should do so here as well.

[98] *See, e.g.*, Comptel at 13-14; MCI at 35.

structure reforms in both the access charge reform and the Universal Service proceedings. Independent of market pressures, the starting point of restructured terminating access rates will be much lower than it is today.

Second, and more fundamentally, it is simply not true that terminating access will be "insulated from competitive pressures" as Comptel suggests. To the extent that an incumbent or competitive LEC attempted to keep terminating switched access rates artificially high, IXCs will have both the incentive and ability to serve that geographic market by purchasing and integrating unbundled network elements with their long distance services. Local transport and termination prices will serve as an effective constraint against unwarranted increases in terminating access.[99]

Third, there are also good reasons to believe that even if the identified "call externality" of the cost being paid by the caller were significant (and again, there is no evidence to believe that it is), any terminating access problem would be effectively internalized through negotiation between parties making and receiving calls and through other market mechanisms."[100] There is no need for a regulatory response.

Finally, to the extent that an issue ever did evolve with respect to the price of terminating access, the FCC complaint process will be more than adequate to police it. BellSouth agrees that IXCs will surely object if they feel they are being manipulated or squeezed by either CLEC or ILEC prices.[101] The Commission should not risk all of the evils of a prescriptive approach when it

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99 *See* SpectraNet at 8.

100 *Sidak & Spulber* at 12. For example, if a LEC overpriced terminating access relative to originating access, there would be incentives for any pair of callers to alter the pattern of their calls to favor the lower-priced alternative so as to reduce the overall costs of making calls between them. *Id.* at 12-13.

101 *See* SpectraNet at 9.

is both unlikely that there will be a problem and certain that existing regulatory mechanisms can address it.

E. The Commission Should Adopt USTA's Updated X-Factor And Reject The Newly Minted And Absurdly High Productivity Estimates Of The IXCs

Although the Commission completed an interim review of the LEC X-Factor in 1995, AT&T and MCI are tireless in their efforts to urge the Commission again to raise it. The evidence presented both in this docket and in Docket No. 94-1, however, shows that there is no reason for the Commission to do so. The X-Factor proposals of AT&T and MCI are riddled with errors and fatally flawed.[102]

First, USTA and BellSouth have documented extensively the flaws upon which the AT&T and MCI productivity estimates are based. USTA and BellSouth have each demonstrated, for example, that AT&T's Norsworthy "productivity" analysis incorrectly measures *every* component of LEC productivity.[103] Similarly, USTA has shown the MCI-computed X-Factors, calculated without reference to LEC productivity measures and based on the accounting earnings of price cap LECs, to be dishonest and methodologically absurd.[104]

Second, and more dramatically, USTA has submitted an updated Christensen Total Factor Productivity (TFP) study with results through 1995 that demonstrates that LEC productivity

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102 *See Notice* at ¶ 233; ATT Comments, CC Docket No. 94-1 (Jan. 11, 1996); MCI Comments, CC Docket No. 94-1 (Jan. 11, 1996).

103 *See* Christensen Associates, "Critique of the AT&T Performance-Based Model," Attachment 6, USTA Comments (Jan. 29, 1997). *See also* Reply Comments of BellSouth, CC Docket No. 94-1 (Mar. 1, 1996) & Attachment 1, Frank M. Gollop, "An Economic Analysis of the AT&T and Ad Hoc Comments" (Mar. 1, 1996).

104 *See* USTA Ex Parte in CC Docket No. 94-1, "Response to MCI Productivity Analysis."

growth has exceeded that of the U.S. economy by 2.7% a year.[105] If anything, the results of the Christensen Update suggest that the X-Factor should be *lowered* and not doubled or tripled in the manner that AT&T and MCI suggest.

Once again, notwithstanding the claims of AT&T and MCI, the record simply does not justify an increase in the LEC X-Factor. The Christensen Simplified TFP Method remains the only credible record evidence of a realistic productivity target that is appropriate for LECs in the remaining years of transition to full local exchange competition. BellSouth once again urges the Commission to adopt it.

V. CONCLUSION

The LECs have long awaited the commencement of an access charge reform proceeding. The expectation is that the Commission will improve the existing set of regulations in a manner that is consistent with the pro-competitive and deregulatory aims of the Telecommunications Act. This result can only be obtained by a progressive regulatory approach that recognizes the role of

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[105] L. Christensen, "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding," Attachment 5, USTA Comments (Jan. 29, 1997).

the marketplace. Accordingly, the cornerstone of access reform should be an adaptive regulatory plan that relaxes regulatory constraints in a manner coincident with the expansion of competition.

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CERTIFICATE OF SERVICE

I hereby certify that I have this **14th day of February, 1997** served the following parties to this action with a copy of the foregoing **REPLY COMMENTS** by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties on the attached service list.

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